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International Economic & Energy Weekly

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20 April 1984

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DI IEEW 84-016
20 April 1984

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International Economic & Energy Weekly

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For at least the next year, we see little room for the new civilian government of Raul Alfonsin to make substantial cuts in military spending. Although Alfonsin is critical of the political role of the armed forces, he is publicly committed to a strong defensive capability, and he is acutely aware that the military poses the most serious long-term threat to his government. 25X1

31 **Israel: A Primer on Triple-Digit Inflation** 25X1

Triple-digit inflation has been the norm since 1978, yet Israel has so far avoided the social and political chaos normally associated with such rapid and persistent inflation. We believe any Israeli government is unlikely to impose the austerity policies needed to slow inflation unless forced to do so by a foreign exchange crisis. 25X1

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Perspective

South American Debt: The Signs To Watch 25X1

South American debtors will continue to be plagued by cash strains throughout 1984, but we believe flexibility between debtors and creditors can avert even more serious international financial disruptions. While commercial banks will probably reschedule and refinance old debts, they will remain reluctant to resume large-scale new lending, a factor that will keep the financial rescue programs on a knife edge. Moreover, new bank funds are likely to be disbursed unevenly, and this could contribute to periodic crises. 25X1

With limited reserves and heightened resistance to making additional import cutbacks, we believe most South American debtors will again resort to temporary payments suspensions to cope with cash strains. The Argentines and Venezuelans are currently from one to three months behind in their payments, while the Brazilians probably will go into arrears if there is a cutoff in bank funds. These payments delays will be headline catching but also will play an important role in preventing financial strains from becoming unmanageable and from undermining the mutual cooperation necessary to deal with the region's debt problems. If these payments delays are not tolerated by international creditors, we believe the region's debtors will be unable to honor external obligations and sustain necessary economic adjustments. 25X1

The rescue programs could unravel from external shocks. A continuing danger is a major jolt to confidence caused by an unanticipated action on the part of creditors or debtors such as Argentina or Brazil. Even a modest increase in world interest rates, oil prices, or a slowdown in OECD recovery would pose major dangers. 25X1

For the near-term, any abrupt change in South America's export prospects would place the greatest strains on the rescue programs. Sustained export recovery, improvements in the terms of trade, and sound exchange rate policies are necessary to enable Latin debtors to resume regular debt servicing payments. Growing protectionism—manifest in increasing numbers of countervailing duties, import restrictions, and voluntary export restraints—could, however, partially offset the benefits of world recovery this year and heighten the prospects for debt difficulties in the future. 25X1

A less likely possibility is that a sharp cutback in foreign lending—such as occurred in late 1982—would undermine South American political leaders' willingness to honor their debts. On the creditor side, the key sign to watch is the ability of bank advisory committees to assemble and complete loan syndications. Inability to assemble new loans for Chile, Argentina, Ecuador, and Peru, or renewed disruptions in the interbank market could doom rescue programs unless alternative funding—for example, from the US Government or the Bank for International Settlements—were found. 25X1

Heightened domestic resistance to austerity caused by new lending cutbacks risks shifting South American political leaders' support away from the current financial rescue strategy. Embassy and other reliable reporting reveals that support for a tougher posture against creditors is gaining political popularity in Argentina, Brazil, Ecuador, and Peru. Any significant shift away from cooperation with creditors—Argentina is likely to be a bellwether—probably would be preceded by:

- An emerging consensus among Latin financial officials that bankers are unresponsive to requests for improved debt repayments terms.
- The increased influence of nationalists and the willingness of influential policymaking groups to recommend more confrontational tactics in dealing with bankers.
- Rhetorical stridency at Latin debt conferences and growing support for a collective approach to the debt crisis. 25X1

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Briefs

Energy

OPEC Production Strong in First Quarter

OPEC production averaged 17.9 million b/d in the first quarter, marking the third consecutive quarter of output above the cartel's ceiling of 17.5 million b/d. Demand for OPEC oil was spurred in part by unseasonably cold weather in the United States. The cartel's output during the first quarter averaged nearly 2 million b/d above year-earlier levels when anticipation of OPEC's first official price cut caused an unprecedented dropoff in liftings. Continued production above the ceiling in the second quarter would put additional downward pressure on prices because the cartel will face weak seasonal demand. 25X1

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OPEC: Crude Oil Production *Million b/d* 25X1

	Quota	1982	1983 [a]	1984 [b]			
				January	February	March	First Quarter
Total	**17.5**	**18.9**	**17.7**	**18.0**	**17.7**	**18.0**	**17.9**
Algeria	0.725	0.7	0.7	0.6	0.6	0.6	0.6
Ecuador	0.2	0.2	0.2	0.3	0.2	0.2	0.2
Gabon	0.15	0.2	0.2	0.2	0.2	0.2	0.2
Indonesia	1.3	1.3	1.3	1.4	1.5	1.4	1.4
Iran	2.4	2.4	2.4	2.2	2.2	2.4	2.3
Iraq	1.2	1.0	0.9	1.1	0.9	1.1	1.0
Kuwait	1.05	0.7	0.9	0.9	1.0	1.0	1.0
Libya	1.1	1.2	1.2	1.2	1.2	1.1	1.2
Neutral Zone	[c]	0.3	0.4	0.5	0.5	0.5	0.5
Nigeria	1.3	1.3	1.2	1.4	1.6	1.6	1.5
Qatar	0.3	0.3	0.3	0.4	0.4	0.4	0.4
Saudi Arabia	5.0 [d]	6.3	5.0	5.1	4.6	4.6	4.8
United Arab Emirates	1.1	1.2	1.2	1.2	1.2	1.2	1.2
Venezuela	1.675	1.9	1.8	1.7	1.8	1.8	1.7

[a] Estimated.
[b] Preliminary.
[c] Neutral zone production is shared equally between Saudi Arabia and Kuwait and is included in each country's production quota.
[d] Saudi Arabia has no formal quota; it will act as swing producer to meet market requirements.

Oil Company Problems in Nigeria

A shortage of lube oil and spare parts for drilling rigs and other equipment could cause Nigeria to fall short of its production goal of 1.4 million b/d in April. According to US Embassy reporting, Nigerian restrictions on lubricant imports and other items have caused serious operating problems for Mobil and Shell who were forced to shut down some production facilities early this month. These companies currently produce over 60 percent of Nigeria's output. In late March officials from Gulf and Shell warned Nigeria's Minister 25X1
of Energy, Tam David-West, that they would curtail production unless the government granted licenses for lube oils. Shell—Nigeria's largest equity producer—was granted an emergency import license early this week, but other producers have not yet received licenses. The oil minister's inability to secure 25X1
licenses reflects a lack of cooperation among Nigeria's ministries, 25X1

Oil company representatives are facing other difficulties as well. They are concerned about recent arrests and interrogations of expatriates for alleged illegal sales of bunker fuel. The captain of a support vessel was taken aboard a Nigerian Navy patrol boat for questioning at a Mobil oil-loading facility late last month but was later released. Companies fear that specialized technicians and other key personnel may refuse to work in Nigeria if harassment continues. 25X1

Nigeria Awards Gas Contract

Nigeria has embarked on an ambitious program to tap the country's huge gas reserves. Lagos is expected to award a contract for construction of a gas treatment plant at Warri and a gas pipeline to Escravos to a West German–Soviet–British consortium later this month. The government has announced 25X1
that the project will be financed by the World Bank and the European Investment Bank. The gas production project is part of the former government's $550 million gas distribution scheme that will supply power-generating stations and industrial consumers. The contract for a connecting 380-kilometer, 36-inch pipeline that eventually will carry gas from Escravos along the coast to Egbin Lagon, near Lagos, was awarded in late 1983 to Italy's Saipem and Snamprogetti. Although the planned capacity of the Lagos gasline is 30 million cubic meters per day, this volume will not be achieved soon because of limited demand. Nigeria currently has only 12 commercial gas users. 25X1

Pertamina Under Fire

The US Embassy reports that Indonesian President Soeharto has ordered the country's national oil company, Pertamina, to improve its management and efficiency. The country's oil and gas export earnings fell $2 billion short of its 1983 target. The government is concerned about apparent payoffs of senior-level officials in Pertamina and recently announced a new marketing plan to 25X1
reduce oil price discounting. In addition, foreign contractors have expressed concern about the operating style of Pertamina's chief, Joedo Sumbono, who reportedly is unwilling to discuss operational problems with lower management and confers only with his closest senior advisers. 25X1

Possible Taiwanese Nuclear Reactor Orders

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We expect Taiwan to request bids for two nuclear power reactors later this year. The United States is in a strong position to win the orders. Bidding on the proposed plants was postponed nearly two years ago as a result of slow economic growth, budget deficits, and lowered expectations for future electricity demand. The economic recovery beginning in 1983 has been accompanied by a sharp increase in electricity demand, and Taipower, the electric power company, is pressing for government approval to proceed with the nuclear project. [redacted] 25X1

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International Finance

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[redacted]

South Korean Loan Well Received

Korea Exchange Bank's $650 million syndicated loan attracted broad participation from international bankers, which reflects South Korea's continued sound credit rating. The loan was increased in two steps from the originally sought $500 million. Terms were slightly more favorable to South Korea than those for its last major borrowing; three-fifths of the loan was priced at 0.75 percentage point over LIBOR and two-fifths at 0.2 percentage point over US prime. Japanese banks were particularly active in the loan, and they reportedly

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plan to increase their Korean exposure this year. International creditors have been impressed with South Korea's recent economic performance—notably Seoul's success at reducing inflation and the current account deficit while maintaining rapid economic growth. With the loan, Seoul has lined up about half of the commercial funds it will seek this year. [redacted] 25X1

Brazilian Foreign Payments Concerns

Despite Brazil's impressive external performance for the first quarter, the government has become increasingly worried that recent unfavorable trends in foreign markets will jeopardize prospects for paring this year's current account deficit to less than $6 billion. Brasilia has complained that foreign import restrictions, such as the US-imposed 27-percent duty on specialty steel items and EC measures to constrain purchases of soybeans, will undercut the drive to attain a $9 billion trade surplus. [redacted] Finance Minister Galveas has assailed publicly the recent 1-percentage-point rise in the US prime interest rate and the related rise in the LIBOR rate. This increase, if its persists through the rest of the year, will add $750 million to Brazil's current account deficit. [redacted]

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Venezuelan Progress Toward Debt Rescheduling

Venezuela has improved its prospects for a major debt rescheduling agreement later this year. The US Embassy reports that the government recently repaid almost all of the estimated $225 million in overdue interest on the public-sector debt. This enabled US banks to avoid classifying these loans as nonperforming at the end of the first quarter. To break the impasse in the negotiations on rescheduling, Venezuela has promised to begin paying $900 million toward interest on the private-sector debt. [redacted] 25X1 25X1

The interest payments and President Lusinchi's new economic adjustment program are important steps in arranging the refinancing of the $14 billion due to banks this year. International bankers are waiting to see whether Caracas follows through on its promise to begin paying overdue private-sector interest, which will require the government to provide foreign exchange. We believe Caracas is likely to tap its $11 billion in reserves to repay these debts, thereby opening the way for a rescheduling agreement. [redacted] 25X1

IMF Defers Action on Peru's Standby

The IMF's recent deferral of action on Peru's new standby agreement has heightened financial and political difficulties for the Belaunde administration. According to a US Embassy report, the Fund's action was prompted by Lima's failure in the first quarter of this year to implement measures to reduce the government deficit, including price increases for foodstuffs and lower corporate tax exemptions that were called for in Peru's IMF stabilization plan. Despite the Fund's action, the Embassy reports that President Belaunde continues publicly to support IMF-guided austerity. Moreover, US Embassy contacts with various political and economic leaders during the week of 9-13 April indicate considerable support for the IMF package. [redacted] 25X1 25X1

Until differences between Lima and the Fund are resolved, Peru's financial position will remain precarious. Foreign bankers question the Belaunde administration's ability to implement austerity and may delay providing additional financial relief for Peru without an approved IMF letter of intent. A continuing impasse between Lima and the IMF could jeopardize economic assistance flows from the World Bank and Western governments as well. [redacted] 25X1

Global and Regional Developments

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Big Six Economic Outlook Brightening

[redacted]

Leading economic indicators for the Big Six are rising at an average 8-percent annual rate, pointing to continuing economic expansion through 1984. The indicators suggest that Japan and Canada will again post the fastest GNP growth rates among the Big Six this year. Although Japan could achieve a larger increase in growth this year compared with 1983, the rate of growth for the Canadian economy probably will ease somewhat in 1984. [redacted] 25X1

Faster growth in consumer credit and orders for investment goods point to a steady West German expansion in 1984. This should lay the foundation for improved GNP growth throughout Western Europe, particularly in France, which is West Germany's largest trade partner. Although France has only a sluggish recovery under way, a broad advance among its leading indicators, including a striking 74-percent rise in stock prices since January 1983, show that the stage may already be set for more rapid growth later in 1984 as foreign demand perks up. The Italian economy probably will start its recovery this year as slower inflation takes a smaller bite out of incomes. The British economy appears likely to grow only a bit faster than last year's 2.5 percent. [redacted] 25X1

China's Search for Iron Ore Imports

[redacted]

China is seeking assured supplies of iron ore for the $5 billion Baoshan Steel Mill, scheduled for initial operations in September 1985. Baoshan's two blast furnaces will need about 10 million metric tons of high-quality iron ore a year that China does not produce and will be forced to import. China currently intends to acquire the majority of the ore from Australia, and the two countries will soon establish a joint working group to determine how much ore Australia will be able to provide. Imports from Australia will be supplemented by ore from Brazil. Chile and India have expressed interest in supplying ore to China, but Beijing has not yet pursued discussions with either country. [redacted] 25X1 25X1

National Developments

Developed Countries

Israeli Public-Sector Workers Receive Wage Advance

The Finance Ministry is undermining its stated policy of attempting to reduce domestic demand through cuts in real wages by granting a cost-of-living advance to public-sector workers. The workers have received 12,000 shekels—$71 at current exchange rates—as an advance on the cost-of-living adjustment 25X1 originally scheduled to be paid in May. The Finance Ministry said the advance was to help Israelis make necessary purchases for Passover and denied press speculation that this was "election economics." The Ministry claimed a similar 25X1 advance was given last year. The Histadrut—the labor federation that represents most 25X1 Israeli workers and employs many of them in its own enterprises—announced similar plans for its workers, and the private sector almost certainly will grant an advance as well. 25X1

Setback on Italian Labor Legislation

Communist maneuvering has set back Prime Minister Craxi's effort to limit wage increases, which is a major element of his economic program. Craxi has failed to obtain parliamentary approval within the required 60-day period for legislation to limit the inflation adjustment in wages. Maneuvering in parliament by the Communist Party delayed a final vote on the bill. Press reports 25X1 state that the ruling coalition reissued a modified proposal under which wage increases would be limited for six months, as compared with 12 months in the defunct proposal. 25X1

Although the government probably will gain approval for a compromise bill, Craxi's position has been weakened. He tried to use the decree law to avoid the usual informal bargaining with the Communists on a major policy question. The Communists' opposition was designed to underscore their claim that the government cannot move on sensitive issues without their approval and Craxi's confrontational approach has strained the ruling coalition. The Christian Democrats, in particular, object to Craxi's bold leadership style, which has given the Socialist Party the political initiative. The Christian Democrats took the lead in presenting a compromise bill acceptable to the Communists in an attempt to regain the initiative. Craxi's weakened position may tempt some Christian Democrats to try to bring down his government later this spring or during the summer. 25X1

Metalworkers' Strike Averted in West Germany

Leaders of West Germany's pacesetting metalworkers union last week backed off from calling for a strike vote from its 2.5 million membership over the union's demand for a 35-hour workweek. As few as 20 percent of the membership, according to one poll, was willing to strike over the issue. The 25X1 union agreed instead to resume talks with management. Despite tough talk and warning strikes, the West German press believes the union is looking for a facesaving conclusion to its uncharacteristically militant 35-hour workweek campaign. 25X1

Although the possibility of short, selective strikes remains, an industrywide action appears to have been averted. Government and business leaders alike had feared that the shortened workweek with no cut in wages would threaten West German competitiveness and the accelerating recovery. A peaceful settlement would be a political victory for the Kohl government, whose early retirement legislation has helped defuse labor militancy. 25X1

Bundesbank Criticized on US Interest Rate Link

A respected West German economics institute is arguing, for the first time, that the linkage between US and West German interest rates largely results from Bundesbank monetary policy. The West German Institute of Economics (DIW) in West Berlin claims in a recent study that, since the second oil shock in 1979, the Bundesbank's primary goal has been defending the deutsche mark 25X1
(DM) with intervention and interest rate increases. This has caused West German interest rates to move almost in step with US interest rates. DIW contrasts this experience with the period after the first oil shock when Bundesbank policy goals focused on West German growth and price stability and West German and US interest rates frequently moved in opposite directions. 25X1

The DIW study will lend credence to calls from opposition Social Democrats for a decoupling of West German interest rates from US rates. Government and Bundesbank officials continue to insist, however, that such a decoupling is not possible. 25X1

New Japanese Program for High-Technology Materials

MITI is increasing its support for basic research on advanced materials, according to press reporting. Anticipating sales worldwide in these materials of $250 billion a year by the end of the century, MITI has established:

- A 10-year R&D program on a 50-50 cost sharing basis with industry that focuses on ceramics, polymers, metals, and composites.
- Special financial and tax measures for firms working to develop advanced materials. 25X1
- Several new organizations, including the New Materials Technology Development Research Association.

This new research effort follows the conclusion of Phase 1 of the materials research programs within MITI's 10-year Next Generation Industry's Basic Technology Development Project. That project, which began in 1981 and has been supported by $65 million of government funds, is now shifting from basic to applied research on materials. 25X1

Japan Boosts Spending on Biotechnology

Tokyo has allocated close to $50 million for biotechnology R&D in its FY 1984 (1 April 1984–31 March 1985) budget—an increase of 30 percent over FY 1983 levels. The government's seed money indicates that Tokyo regards biotechnology to be a key technology for future commercialization. Moreover, Tokyo has provided additional encouragement to industry through such 25X1
actions as MITI's sponsoring of a 14-company consortium to focus on long-range commercial development of biotechnology. Programs receiving the most emphasis include biomass conversion, DNA-related research, and plant genetics. 25X1

Less Developed Countries

More Storm Damage in Madagascar

A severe cyclone swept across the northern part of Madagascar last week, killing at least 50 people, leaving 75,000 homeless, and causing roughly $100 million damage, according to preliminary government estimates. Two of the country's three most important ports could be closed to commercial activities for some time because of sunken ships and damaged facilities. Power, 25X1 communication, and transportation networks suffered widespread damage. This cyclone and previous storms in recent months are likely to create serious domestic food shortages as well as lower export earnings because of damage in major coffee, vanilla, and sugarcane growing areas. The Malagasy Government is turning to aid donors, including the United States, for emergency assistance to provide immediate food, medical, and shelter needs and for longer term reconstruction efforts. 25X1

Lesotho Food Crisis Worsens

Lesotho will probably request additional emergency food aid from the United States as a result of the drought that has devastated southern Africa for the past three years, according to the US Embassy. The June grain harvest is expected to be only 25 percent of normal, and the Embassy believes that livestock herds could perish during the dry winter months from July to 25X1 September. Lesotho has few logistic problems with the internal distribution of relief supplies, but expected heavy congestion of South African port facilities later this year—caused by increasing food imports to the region—could impede deliveries of food aid to landlocked Lesotho. 25X1

Communist

Conflict Over Economic Reform in Yugoslavia

Prime Minister Planinc warned last week that she and her cabinet will resign unless the legislature quickly approves legislation carrying out her economic policies and ensuring adherence to the IMF program ratified last month, according to US Embassy reporting. Although acknowledging the high cost of complying with the Fund's conditions, Planinc warns that failure to adhere to the program would entail even greater economic sacrifice and that she would 25X1 be unwilling to lead the country under such circumstances. Under the IMF program, a price freeze will be lifted at the end of this month, and interest rates will be raised sharply. Planinc seems to be using the tough IMF program, reinforced by her threat to resign, to help push through her economic stabilization program. She has threatened to resign before, but her evident frustration with the political obstacles impeding stabilization adds weight to her current threat. 25X1

Poland Restricts Price Increases

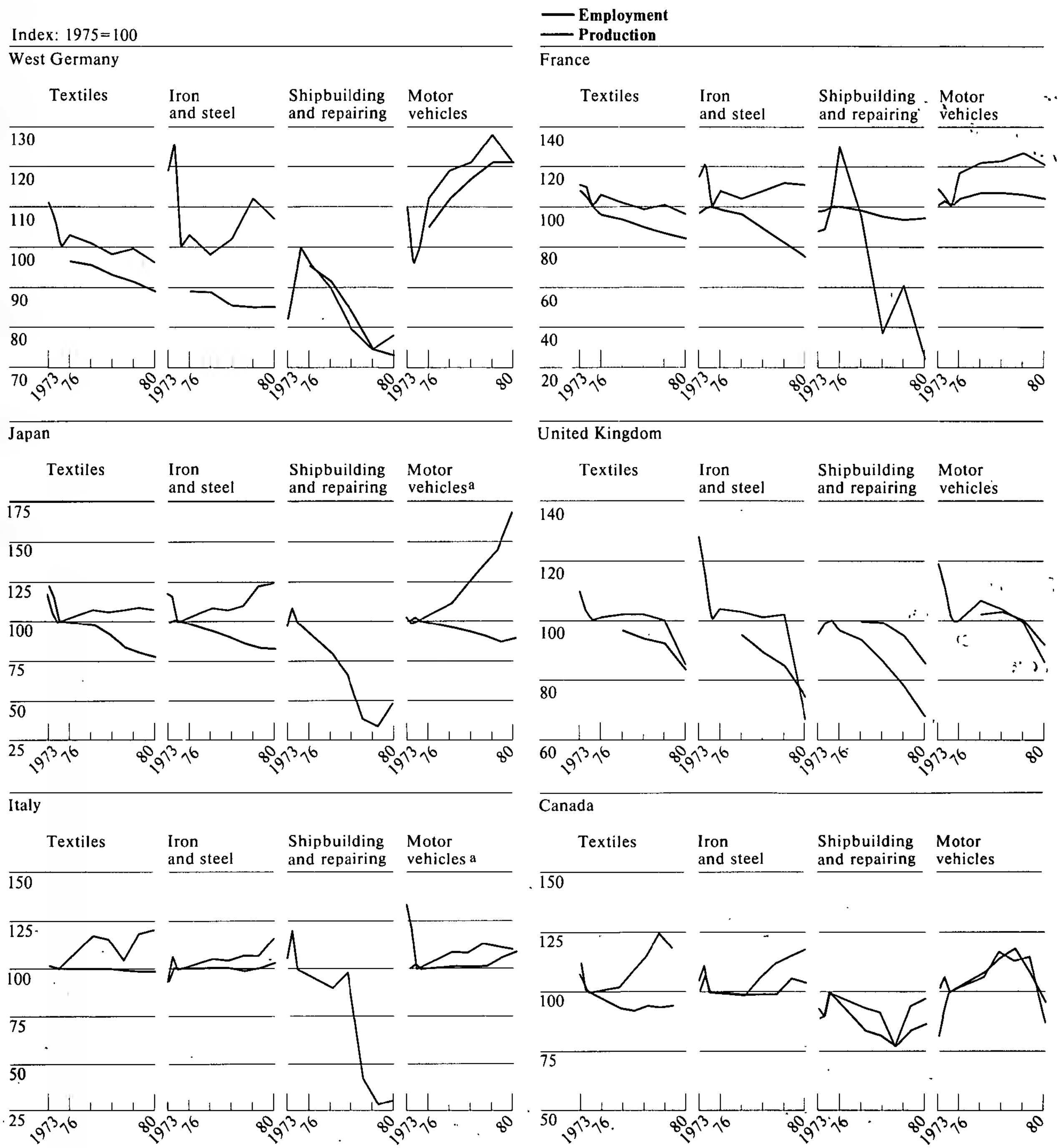
The Polish Government has put an upper limit of 10 percent on retail price increases on many consumer goods this year, probably out of concern about a negative reaction from workers. Prices of almost all consumer goods are expected to rise this month as firms pass on to consumers the extra production costs that resulted from the average 20-percent price increases in March on transportation and inputs such as coal, electricity, and natural gas. The limit on price hikes fulfills promises Warsaw made to workers earlier this year that it would no longer raise prices by large amounts at one time, but would hike prices by smaller amounts throughout the year. The regime probably hopes to bolster the reputation of unions as representative of the workers by attributing the restrictions on price increases to negotiations with the unions. 25X1 25X1

The new price restrictions will make it difficult for Warsaw to persuade Western creditors that it is committed to an austerity program or to market-type reforms. The move will delay an overall realignment of retail prices to balance supply and demand and will increase budget subsidies for consumer goods. 25X1

USSR–Eastern Europe Economic Summit Announced

Soviet First Deputy Foreign Minister Korniyenko has announced that the CEMA summit would be held in Moscow in June. Another Soviet official told the US Embassy in Bucharest that major problems related to the summit either have been resolved or are being worked out. We do not expect the summit to produce substantial changes in Soviet–East European economic relations. East European opposition has forced Moscow to ease its demands for closer economic integration in CEMA. The key issues that probably will be addressed at the summit include the quantity and quality of East European exports to the USSR and East European investment in Soviet development projects in exchange for supplies of energy and raw materials. 25X1 25X1

Big Six Countries: Production and Employment in Four Major Industrial Sectors, 1973-80



[a] Employment is for all transportation equipment.

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Summit Issues: Big Six Industrial Restructuring Efforts

The Big Six countries are attacking the restructuring problem in widely varying ways and with different degrees of success. The Japanese Government has for some time recognized the need to promote new industries, and restructuring there is a relatively smooth evolutionary process. In Western Europe and Canada, governments have only recently begun to address the structural economic rigidities that have inhibited the creation of the new manufacturing sectors necessary to offset job losses in declining industries. The four West European governments, in particular, will have to do considerably more if unemployment is to be brought down to acceptable levels.

The Problem

During the 1970s, a number of old-line industries in the major industrial countries began to lose their international competitiveness because of rapidly increasing labor costs and the advancing industrial sophistication of many LDCs. As a result, manufacturing employment and production dropped steadily in many traditional industries. Japan's shipyards and textile mills lost ground to those in South Korea and Taiwan, while Canada and the Big Four West European countries lost workers in the steel and automobile industries. In contrast, Italy performed best among the West Europeans, retaining employment in textiles and steel by producing high-quality textiles efficiently and switching to lower cost steel minimills.

The Policy Response

Tokyo is far ahead of other countries in grappling with restructuring. Restructuring has taken place continuously throughout the 1970s with sufficient flexibility to reorganize the country's economic base toward new industries. Government support for traditional industries has been aimed at reducing capacity, while government high-technology subsidies have existed for some time. At its peak in 1983, unemployment reached only 2.7 percent.

In Western Europe and Canada, however, shifts have been slow and contributed to the persistent double-digit rates of unemployment. Unlike Japan, many West European governments have not played an important planning and catalytic role. Instead, government regulations have added innumerable delays and expense to doing business and have reduced the private sector's ability to react quickly to changing market conditions. In West Germany, for example, establishing a new business requires applications for up to 150 approvals; moving a plant to a new location entails obtaining several hundred permits. In France, it normally takes two years to incorporate a business. Moreover, the cost of employer-paid employee benefits has cut deeply into profit margins and reduced funds that could have been used for investment. These costs amount to over 80 percent of direct wages in France and Italy, over 70 percent in West Germany, over 35 percent in the United Kingdom, about 30 percent in Canada, but only 17 percent in Japan.

The four West European countries and Canada have only recently begun moving toward a more active and positive role in restructuring. Under the Thatcher government, massive rationalization has taken place in scores of British industries, with concomitant gains in productivity and competitiveness, but also immense job losses. Output per worker in textiles has risen by 25 percent in recent years, while employment has dropped by over 40 percent in the largest textile firm. The West German Government has made limited progress in

Big Six: Government Restructuring Policies

Japan

Tokyo has long been concerned with restructuring. A decade ago the Ministry of International Trade and Industry began pressuring the private sector to develop new high-growth industries and new high-value-added products. Where MITI perceived bottlenecks, it used subsidies and tax breaks to induce change. To speed the diffusion of technology among firms in the microelectronics field in the late 1970s, for example, MITI helped fund a cooperative research project on very-large-scale integrated circuits that brought together researchers from competing companies. In the case of depressed industries, Tokyo has organized capacity-reduction cartels to distribute the burden of cutbacks throughout each industry. MITI remains ready to intervene whenever it perceives an obstacle to the growth of a new industry or sees the need for the smooth decline of an uncompetitive industry. More than any other Big Six country, Japan has moved rapidly into microelectronics and associated industries such as computers, numerically controlled machine tools, robotics, and consumer electronics. 25X1

West Germany

Kohl's restructuring policies are aimed mainly at increasing economic growth by promoting a more market-oriented environment for West German firms. Bonn is just now expanding support for R&D projects conducted in academic and industrial research laboratories and institutes. Moreover, small and medium-sized firms increasingly receive subsidies for their R&D expenditures and generous tax writeoffs for R&D-associated investment. The Ministry of Research and Technology is boosting funding for biotechnology, optical communications, data processing, robotics, microelectronics, high-technology metals and materials, and environmental and public health research. Communications technology and nuclear power also are benefiting from more government support. Nonetheless, the government continues to subsidize traditional industries at an even higher level than its predecessor. 25X1

France

The direction and implementation of French industrial policy has changed significantly in the past 18 months. The Socialists originally planned to increase production and employment in both traditional industries and high-technology industries with government support and selective nationalization. Recent restructuring decisions, such as the planned cutbacks in the steel industry, indicate Paris now is willing to cut support for unprofitable basic industries and to allow private firms more leeway in restructuring. President Mitterrand and his cabinet are increasingly emphasizing the role of small and medium-sized firms in creating jobs and in product innovation. In the past month the government has drafted legislation to increase credit availability to smaller firms and to encourage venture capital. 25X1

Big Six: Government Restructuring Policies (continued)

United Kingdom

The key elements of Prime Minister Thatcher's strategy to restore British industry's flagging competitiveness are rationalizing declining industries, providing incentives to high-technology firms, and making the wage bargaining process more flexible by reducing the power of labor unions. In addition, London expects to increase industrial efficiency and competition by selling off a number of state-owned firms in such sectors as transportation, energy, communications, steel, and shipbuilding. The government hopes that its recent decision to reduce depreciation allowances on capital investment in return for lower overall taxes on corporate earnings will also promote efficiency by pushing corporate investment decisions to meet profitability standards. [redacted] 25X1

Italy

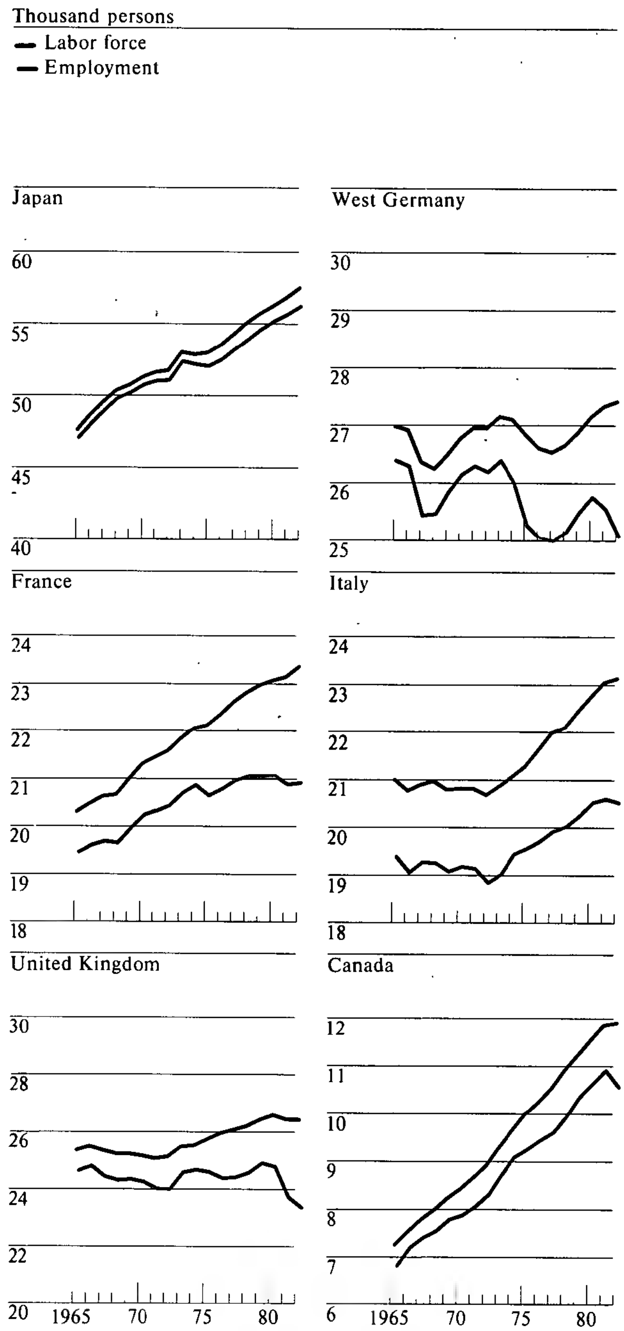
Rome will soon unveil a new industrial policy to assist Italian industries. The government plans to provide fiscal incentives to encourage investment, assist innovation through attractive financing, continue financial support for exports, boost advanced technologies through government research contracts with large enterprises, and aid depressed industries and regions. This new policy, however, appears to be no more than an effort by the Craxi government to better coordinate existing programs and refocus them on high-technology sectors. Moreover, the past performance of government programs makes the creation of a successful industrial policy problematic, at best; funding for previous programs has often been inadequate or has not reached targeted sectors. [redacted] 25X1

Canada

Ottawa has not implemented a national industrial policy toward restructuring because a consensus among the country's political factions has not been attainable— [redacted] 25X1 *As a result, the Canadian Government has attempted to help the restructuring process in a piecemeal manner, relying on development grants and tax incentives to promote R&D activity. Ottawa claims it also is promoting restructuring efforts by reducing foreign control of the economy through the government's purchase of several foreign-owned high-technology firms. Provincial governments in Alberta, Quebec, and Ontario have developed their own industrial strategies as well.* [redacted] 25X1

restructuring. Subsidies for shipbuilding and steel, for example, have increased under the Kohl government, while efforts to support high-technology areas are lagging. Few results are expected from a soon-to-be- announced new Italian industrial policy, although more emphasis on high-technology industries is expected. French Government policies are somewhere in the middle of West European restructuring efforts. President Mitterrand has increased support for R&D in high-technology areas and has told nationalized industries they must be profitable by 1986 or 1987. The main thrust of Canadian restructuring policy has been to lessen foreign control of the economy, which Ottawa believes retards technological advancement.

Big Six Countries: Labor Force and Employment, 1965-82



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Prospects

West European and Canadian governments are likely to increase their efforts to stimulate new industries, but structural rigidities, particularly in Europe, are so ingrained that solutions will be politically difficult to achieve. For example, lowering employment costs to employers by reducing social welfare benefits has already encountered strong opposition in Western Europe. If economic flexibility is not significantly improved, restructuring will continue to proceed slowly, thus causing economic growth over the rest of the decade to be slow at best and unemployment to remain high. In contrast, Japanese growth is expected to be moderately high and unemployment low as the Japanese move quickly to create, produce, and export new products.

The private sector in Western Europe is slowly reacting to restructuring needs. Venture capital, although still scarce, is making an appearance, and over-the-counter stock markets are beginning to take hold, particularly in the United Kingdom and France, thus encouraging the creation of new, innovative companies. Moreover, many West European firms are trying to acquire new technologies through linkages with US and Japanese companies. Such efforts, however, probably cannot offset the existing rigidities in these economies.

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South America: Struggling With Debt 25X1

South American countries face major challenges in obtaining foreign financing this year. In our judgment, the major contentious issues affecting the cooperation of debtors and creditors will be: domestic political resistance to adjustment policies negotiated with the IMF; debtor demands to ease the repayment burden; and banker reluctance to provide new lending. Although lenders are now moving to provide loans and refinance debts, the disbursements of credit are likely to fall short of South America's new money requirements. Under the most likely circumstance, we believe that debtors will be able to manage their liquidity strains in 1984. Nonetheless, with limited reserves and heightened resistance to additional import cutbacks, most borrowers probably will again resort to temporary payments suspensions to cope with cash strains.

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There is a continuing danger, however, that a major jolt to confidence could occur caused by an unanticipated action on the part of creditors or debtors. Even a small increase in world interest rates, a slowdown in OECD recovery, or growing protectionism would pose major dangers. If unmanageable cash strains develop, we foresee a cessation of foreign exchange payments from South America and serious financial losses for US banks. In our worst case, Argentina or Brazil would probably resort to radical actions if bankers ceased cooperating with their rescue programs. This likely would tempt Chile, Peru, and Venezuela to follow suit, probably causing their rescue programs to collapse. South America's problems then probably would spill over to other Third World borrowers, such as Mexico and Nigeria.

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Financial Adjustments in 1983

Economic retrenchment, the gathering momentum of world recovery, and the application of tight foreign exchange controls enabled South American countries to reduce their current account deficit an estimated 60 percent to $12.4 billion last year. Despite a 1-percent decline in South America's exports, the region's trade surplus rose to $17 billion mainly because of a 25-percent cut in imports. Meanwhile, there was a nearly $5 billion decline in the service deficit to $29.5 billion, mainly reflecting lower interest rates. The payments performance on a country-by-country basis was uneven. The major debtors—namely Brazil, Argentina, and Venezuela—improved their payments accounts, while the smaller countries, notably Bolivia and Colombia, suffered setbacks. 25X1

Although commercial banks rescheduled old debts, they remained reluctant to resume large-scale new lending in 1983, causing cash strains for South American debtors. Nearly all of the borrowers that raised new loans did so only in connection with their IMF adjustment packages. Although foreign banks committed over $8 billion under these programs, Brazil, Argentina, and Peru were temporarily cut off from IMF monies during the year because of compliance problems with their Fund programs. Arrearages accumulated, leaving South American countries nearly $7 billion behind in payments at yearend, according to estimates based on press and US Embassy reporting. Argentines owed nearly $3 billion in public- and private-sector debt payments at the end of 1983, and the Brazilians were about $2 billion behind in debt servicing and import payments. Embassy and banking sources indicate Venezuela's private sector had nearly $1 billion outstanding to creditors, while Ecuador and Bolivia together had another $1 billion past due. 25X1

Major South American Debtors: Foreign Financing Requirements [a] *Billion US $*

	1982	1983 [b]	1984 [c]
Current account balance	−29.9	−12.4	−13.0
Trade balance	4.2	17.1	18.6
Exports	57.5	56.9	61.0
Oil	20.0	17.9	18.0
Nonoil	37.5	39.0	43.0
Imports	53.3	39.8	42.4
Oil	11.8	9.3	8.5
Nonoil	41.5	30.5	33.9
Net services	−34.1	−29.5	−31.6
Interest payments [d]	25.2	21.0	23.5
Other	8.9	8.5	8.1
Arrearages	0	3.3	6.8
Scheduled principal repayments	14.9	24.9	41.7
Foreign financing requirements [e]	**44.8**	**40.6**	**61.5**

[a] Table includes Brazil, Argentina, Venezuela, Ecuador, Chile, Peru, Bolivia, and Colombia.
[b] Estimated.
[c] Projected.
[d] Scheduled interest payments minus arrears.
[e] Foreign financing requirements equals current account balance plus scheduled principal repayments on medium- and long-term debt plus previous year's arrearages.

[redacted]

The external improvements were managed at high political and social costs. Import retrenchments and tough exchange controls contributed to a decline in real output in most South American countries in 1983, ranging from 1 percent in Chile to 12 percent in Peru and Bolivia. Moreover, economic adjustment programs caused more inflation last year than Latin leaders expected. The consequent decline in real wages accompanied by growing unemployment intensified social strains throughout much of the region. [redacted] 25X1

The Challenge Ahead

The problem facing South American debtors and their creditors is how to maintain cooperation when both sides apparently feel they are reaching their limits of flexibility. The financial rescue strategy continues to rely on the case-by-case approach for treating the debt-troubled countries, and bankers are again looking to the IMF to oversee the needed reforms in return for financial assistance. [redacted] 25X1

South American political leaders, however, are intensifying pressure on creditors to ease the adjustment burden, especially the conditionality that is included in their IMF programs. An increasing number of South American debtors are also voicing opposition to the high interest rates and front-end fees charged by banks for new and restructured loans. [redacted] 25X1

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Unless a high degree of financial cooperation continues, South America will again face unmanageable financial strains this year. We estimate the region will probably require $62 billion to cover the current account deficit, refinance loans, and clear arrears in 1984. In our opinion, the major hurdles to secure financing are: reaching a revised IMF agreement for Argentina; negotiating new money for Ecuador and Peru; and working around Bolivian and Colombian unwillingness to undertake adjustment programs. [redacted] 25X1 25X1

Bankers are negotiating agreements to reschedule debts and provide new funds, but only to those countries that have concluded IMF-backed programs. [redacted] 25X1 international lenders agree that they have little practical choice but to continue financial support. Already, bankers have raised $6.5 billion for Brazil, lowered interest spreads, and extended repayment periods for Brazil and Ecuador in new rescheduling agreements and have agreed in principle to provide Chile about $800 million in new loans this year. [redacted] 25X1

Major South American Debtors: Lender Commitments Versus Foreign Financing Requirements, 1984

Billion US $

	Foreign Exchange Requirements	Lender Programs	Firm Commitments [a]	Current Foreign Exchange Gap	Foreign Financing Under Negotiation [b]	Exchange Gap or Surplus End of 1984 [c]
South America						
Current account deficit	13.0	New money	6.7	6.3	9.2	2.9
Principal repayments	42.2	Reschedulings	13.7	28.5	28.5	0
Brazil						
Current account deficit	7.0	New money	6.5	0.5	4.1	3.6
Principal repayments	7.9	Reschedulings	7.9	0	0	0
Argentina						
Current account deficit	2.2	New money	0	2.2	2.5	0.3
Principal repayments	12.0 [d]	Reschedulings	0	12.0	12.0	0
Venezuela						
Current account surplus	1.8	New money	0	1.8	0	1.8
Principal repayments	16.4 [d]	Reschedulings	0	16.4	16.4	0
Ecuador						
Current account deficit	0.5	New money	0	0.5	0.5	0
Principal repayments	1.1	Reschedulings	0.6	0.5	0.5	0
Chile						
Current account deficit	1.4	New money	0	1.4	1.5	0.1
Principal repayments	2.1	Reschedulings	2.1	0	0	0
Peru						
Current account deficit	0.9	New money	0	0.7	0.6	−0.1
Principal repayments	1.1	Reschedulings	1.5	0.8	0.8	0
Bolivia						
Current account deficit	0.4	New money	0	0.4	0	−0.4
Principal repayments	1.0	Reschedulings	0	1.0	1.0	0
Colombia						
Current account deficit	2.4	New money	0	2.4	0	−2.4
Principal repayments	0.6	Reschedulings	0	0.6	0.6	0

[a] As of January 1984.
[b] Includes IMF credits.
[c] Assumes that all financing under negotiations is disbursed by the end of December.
[d] Includes 1983 and 1984 principal repayments.

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The leaders of the large debtor countries generally support the overall objectives of the IMF-backed financial rescue programs. [redacted] most leaders recognize the need to retain access to world capital markets to secure trade credits for essential imports, development loans, and technology transfers. [redacted]

These incentives to cooperate are partly offset by growing political resistance to austerity through much of South America, notably Brazil, Peru, and Argentina, making some backsliding on commitments to the IMF likely. We believe that difficulties in complying with the IMF accords will make new loans from commercial bankers harder to secure than in 1983. Additionally, with some 30 IMF-endorsed financial rescue programs now under way worldwide, this could cause delays in new loan syndications and disbursment of credits to the South America borrowers in 1984. [redacted]

Financing Needs in 1984

South American governments have little choice but to continue foreign borrowing to meet their current payments obligations. Even though we believe a healthy OECD recovery will encourage export growth, oil prices will stay at $29 per barrel and LIBOR at 9 percent, our projections indicate that the South American debtors will require some $13 billion in new loans this year to finance their current account deficit. After a year of severe cutbacks in foreign purchases, most South American countries are unwilling to cut imports further to avoid causing domestic economic disruptions. The region's limited foreign exchange reserves preclude a substantial drawdown to help finance the deficit. [redacted]

Although private bankers and official creditors have already started negotiations to meet these requirements, we believe lending will fall short of borrowing needs in 1984. Loan disbursements will probably continue to be interrupted, while rescheduling agreements will remain difficult to conclude. As a result, we foresee three possible outcomes—persistent but manageable liquidity strains, a widespread unraveling of rescue programs, or an easing of financial difficulties, depending on creditor and debtor willingness to cooperate. [redacted] 25X1

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Liquidity Strains Persist

We believe there is a 7-in-10 chance that cash flow difficulties will continue, but will not lead to a rupture in relations between creditors and debtors. Brazil, Peru, and Ecuador will probably be unable to meet their IMF commitments, causing temporary funding gaps, but we anticipate IMF flexibility in renegotiating these programs, thus ensuring the borrowers' ability to regain access to commercial credits. Delays in obtaining new money, however, will probably cause the most serious liquidity strains, especially for such countries as Argentina, Bolivia, and Colombia. [redacted] 25X1

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In this scenario, we believe that the debtors are unwilling to adjust to credit shortfalls by new import cuts or large reserve drawdowns. Instead, they will move to alleviate cash strains by running large arrearages. Some debtors, notably the Argentines, may implement long payments delays, but such suspensions probably would be grudgingly tolerated by international bankers. Payments delays enable the debtors to bridge cash shortages until the influx of new credits ease liquidity strains. Moreover, the continued extensions of past-due principal repayments—notably by Venezuela—provide the time necessary to conclude rescheduling agreements. [redacted] 25X1

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The Programs Unravel

Although we think it unlikely—two chances in 10—the financial rescue programs could begin to unravel if bankers refused to supply new loans, perhaps in retaliation to hardline bargaining tactics by South American debtors or simply because of poor repayment prospects for the region as a whole. A cutoff in new lending would leave foreign credit as much as 40 percent short of covering South America's current account deficit, causing unmanageable liquidity strains. Under these conditions, 25X1

we believe Brazil, Bolivia, Chile, and other South American debtors could suspend indefinitely principal repayments and curtail interest payments. Regional action to force bankers to provide debt relief would become more likely, and the breakdown of international cooperation could ultimately lead to the near cessation of foreign exchange payments by South American governments. Moreover, banker unwillingness to cooperate would increase the probability of an outright repudiation by one of the debtors, especially the Argentines. [redacted] 25X1

Financial Progress

The least likely scenario, in our view, is one in which lenders make every effort to provide promised financial assistance, thereby easing liquidity strains dramatically. In this case, lenders might disburse roughly $16 billion in new loans—about 25 percent more than necessary to meet 1984 current account requirements—in support of sustaining adjustment efforts and replenishing reserves by debtors, and bankers reschedule all outstanding obligations. Even under these conditions, however, the financial rescue programs would have little margin for error. Brazil, Chile, and Venezuela probably would still encounter difficulty in obtaining additional credits needed to fund new investment projects, while Bolivia and Colombia probably would grapple with cash-flow difficulties unless they agreed to rescue programs under the IMF. [redacted] 25X1

Vulnerability to External Shocks

New external shocks would heighten the odds of the programs' unraveling and producing our worst case outcome. A major jolt to confidence caused by an unanticipated action by debtor or creditor will remain a continuing danger. A runup in world interest rates and oil prices, or an aborted OECD recovery could quickly result in unmanageable cash strains. A 1-percentage-point increase in world interest rates would add as much as $1.6 billion to South America's annual debt servicing requirements in 1984. Moreover, a 1-percentage-point slowdown in OECD recovery or a $1 rise in oil prices could add $1-1.5 billion to South America's total current account deficit. [redacted] 25X1

Brazil potentially would be the most severely affected by new shocks and would probably encounter serious difficulties in obtaining sufficient sources of new funds, setting the stage for a confrontation with its creditors. The danger in such a confrontation is that Brasilia would declare a payments moratorium instead of temporarily halting loan repayments. Bankers fear—and we share their concern—that other South American debtors would follow, leading to the withdrawal of trade financing and interbank deposits. Under such conditions, South America's difficulties would probably spill over to other Third World borrowers. [redacted] 25X1 25X1

Implications for the United States

South America's financial difficulties will continue to hurt US commercial interests in 1984. According to our estimates, the US current account surplus with the region deteriorated to $2.3 billion in 1982 and probably moved into a deficit last year as US exports fell sharply and interest income from the region slowed. The potential for commercial disputes has also increased. [redacted] 25X1 tight import controls and exchange restrictions are causing difficulties for US exporters and investors trying to repatriate funds from their subsidiaries. US financial institutions will continue to be vulnerable to debt servicing disruptions. [redacted] 25X1 25X1

US long-term commercial and political interests could suffer as long as South America's precarious external finances continue. Tighter foreign exchange restrictions and new investment controls could result from rising economic nationalism. Intensified import-substitution efforts would permanently restrict US sales and investment in the region. Moreover, economic discontent could translate into political instability and increased hostility toward the United States. [redacted] 25X1

[redacted] 25X1

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International Financial Situation: Political Update

Foreign financial difficulties and economic adjustment programs in debt-troubled LDCs continue to spur domestic political turmoil, particularly in South America. Economic hardships have helped spark cabinet changes, strikes, and protests during the past month in Chile and Peru, which are in the midst of negotiating new agreements with the IMF. Political pressures are forcing an easing of austerity in both countries. In contrast, Bolivia has announced severe new austerity measures with the apparent backing of the military. President Alfonsin of Argentina, in office just four months, has already seen the end of his political honeymoon, and we expect opposition to his economic policies to mount. In the Philippines and Brazil, election politics have pushed financial difficulties out of the headlines. Because the underlying political divisions will not be resolved any time soon, continued economic decline will only aggravate the situation in both countries.

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Renewed political conflict in **Chile** over the past month has taken various forms—a national day of protest over the slow pace of political liberalization and continued high unemployment, the replacement of the Ministers of Economy and Finance, and plans by opposition labor groups for a general strike. The middle and working classes participated extensively in the 27 March national protest. Although the Pinochet government invoked a state of emergency, a curfew, and press censorship, these moves failed to contain the demonstration. This failure may cause some rightist politicians and military officers to question the government's hardline approach. Pinochet also is trying to undercut support for the protest movement by taking steps to reduce unemployment. The new economic team is publicly talking of cautious expansionary measures in order to avoid confrontation with the IMF and international bankers, but we believe political pressures will force more expansionary moves.

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Peru's Prime Minister resigned earlier this month in a protest against President Belaunde's willingness to countenance new economic policies that run counter to IMF proposals, according to the US Embassy. The press reports that the new economic team is working on proposals for heavy government spending to reactivate the economy, but Belaunde continues publicly to support IMF-guided austerity. The IMF has put off a decision on accepting a new agreement with Peru until the situation clarifies. According to press reports, a Finance Ministry official has said that Peru wants to change the accord to forestall a social and political explosion.

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Bolivia, which has long avoided an IMF agreement, announced this week a 75-percent devaluation and 300- to 400-percent price increases for basic foods and gasoline. We believe the decision last week by the social democratic Movement of the Revolutionary Left to rejoin the government coalition encouraged President Siles to act. According to press reports, military leaders also are supporting the government's tough new measures. The country's powerful labor unions, however, are organizing protest rallies against them; after a successful three-day general strike, they are now holding off a decision on an indefinite strike, pending discussions with government representatives.

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President Alfonsin's ambitious program for reforming the **Argentine** military and the labor unions has stalled. The opposition-controlled Congress has rejected his proposal for the election of union leaders, and the trials of former military leaders have moved slowly. On the economic front, a last-minute multination aid package averted a confrontation with bankers last month over the payment of overdue interest, but the government now must

devise an economic adjustment program acceptable to both the IMF and the Argentine public. Trying to gain congressional approval of an austerity budget and an IMF accord will be a severe test of the new President's ability to hold his opponents in check. Buenos Aires's announcement that it will trim cost-of-living adjustments already has been denounced by the opposition Peronists and the unions. [redacted]

As the **Philippines'** 14 May National Assembly elections get closer, President Marcos's ruling party is concerned about its prospects in several key areas. [redacted] the party estimates that, of the 183 elected seats at stake, at least 53 could go to the opposition in a fair fight. In our judgment, the opposition could win as many as 80 seats in the absence of widespread cheating by the ruling party. Marcos, however, probably will not allow the opposition to control even 30 percent of the seats. With just 20 percent, the opposition could initiate presidential impeachment proceedings. As a result, extensive fraud is likely in the areas where the party believes it is weak. [redacted] 25X1

In **Brazil**, mass demonstrations in favor of direct balloting in the January 1985 presidential election have temporarily pushed economic problems out of the limelight. According to press reports, rallies drew 1 million people in Rio on 10 April and even more in Sao Paulo on 16 April. The series of demonstrations held since January is intended to pressure Congress to approve a constitutional amendment substituting direct elections for the current electoral college system dominated by the government party. Although Brasilia hopes to defeat the amendment through the absence of a quorum, the US Embassy suggests that the bill has a fair chance of passing the lower house. In search of a compromise, Figueiredo has proposed a substitute amendment. It would trim the next presidential term from six years to four, allow direct elections in 1988, and grant Congress a greater role in decisionmaking. Recent statements by military officers are intended to intimidate Congress and halt the direct-elections campaign, but the armed forces still appear determined to proceed with a measured transition to civilian rule [redacted] 25X1 25X1 25X1 25X1

[redacted] 25X1

The Argentine Military: Impact of the Economic Crisis

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The Argentine military has been insulated from fluctuations in economic performance and appears unlikely to suffer significantly even from the current difficulties. Contracts for most major equipment acquisitions were signed before the economic decline in 1981, and funds have been set aside to meet delivery payments. Nonetheless, since their recent return to the barracks, the armed forces have focused on less costly upgrading of existing capabilities rather than foreign purchases. 25X1

For at least the next year, we see little room for the new civilian government of Raul Alfonsin to make substantial cuts in military spending. Although Alfonsin is critical of the political role of the armed forces, he is publicly committed to a strong defensive capability, and he is acutely aware that the military poses the most serious long-term threat to his government. Moreover, growing opposition from the Peronists on a range of issues, especially the economy, diminishes Alfonsin's ability and probably his willingness to take on the military by reducing its resources. 25X1

We estimate that any major near-term confrontation between the government and the armed forces would be preceded by a sharp deterioration in the economy leading to widespread social unrest and a serious resurgence of terrorism. Executive or legislative policies that jeopardize the military as an institution could spark a showdown as well. Even then, in our view, divisions between and within each of the services and the current lack of broad popular support would make launching a successful coup difficult. 25X1

Political and Economic Backdrop

Argentine military officers tend to be fiercely nationalistic and in general share a deep distrust of civilian government. The armed forces have moved against elected officials, however, only when civilians, themselves concerned about economic and political instability, have convinced the military that the majority of Argentines backed intervention. Thus, with civilian connivance, the military has overthrown elected governments six times since 1930, most recently in 1976. 25X1

Until the 1976 intervention, military officers played the role of arbiter, holding power only long enough to assure a smooth return to civilian rule. Following the 1976 coup, however, the armed forces were not only guarantors of peace, but became reformers bent on rooting out what they saw as the source of Argentina's chronic instability—leftist subversion, a corrupt labor and political leadership, and economic mismanagement. 25X1

The military assumed office in 1976 amid 400-percent inflation and widespread terrorist violence. The regime adopted measures to stabilize the economy and restore international investor confidence. Exports increased, the public deficit as a share of the GDP dropped, and soaring inflation was slowed dramatically. The economic measures, however, were at a high cost to workers, who saw their living standards drop sharply. At the same time the security forces defeated the leftist guerrillas in the so-called dirty war, during which thousands of suspects were detained and subsequently killed. 25X1

By 1981, pressure for a return to civilian rule had started to build. Economic mismanagement and rapidly accumulating foreign debt, combined with the onset of the worldwide recession, led to an economic downturn. This, combined with the growing realization of the widespread abuses of human rights, had all but discredited the military. The

Argentina: Selected Deliveries of or Contracts Signed for Major Equipment, 1978-83

	Quantity	Approximate Value (*million US $*)
France		**587.2**
Exocet missiles	13	7.0
Mirage III fighters	6	70.0
Antisubmarine warfare frigates	3	120.0
Panhard armored vehicles	127	112.0
Super Etendard naval jets	14	160.0
Roland I SAMs	12	50.0
Exocet missile system	Unknown	8.2
Crotale SAM unit	1	10.0
Mirage V fighters	14	50.0
Italy		**115.9**
Mamba antitank missiles	500	0.5
105-mm towed howitzers	10	1.2
A-109 helicopter gunships	9	30.0
105-mm howitzers	Unknown	1.2
MB-339 jet aircraft	10	30.0
Albatross missile system (with Aspide missiles)	4	3.0
35-mm antiaircraft guns (with associated fire-control radars)	18	50.0
West Germany		**1,872.2**
Submarines	6	464.0
MEKO destroyers/escorts	10	1,286.0
Cobra antitank missiles	780	1.0
Patrol boats	20	110.0
20-mm antiaircraft artillery guns	40	11.2

	Quantity	Approximate Value (*million US $*)
United Kingdom		**187.0**
Type-42 destroyers [a]	2	70.0
Blowpipe SAMs	Unknown	4.0
Unspecified equipment	Unknown	107.0
Lynx helicopters	2	6.0
Austria		**58.0**
PJK self-propelled antitank guns	58	58.0
PJK self-propelled antitank guns (including ammunition)	57	Unknown
Israel		**270.3**
Patrol boats	7	5.3
Mirage V fighters (with air-to-surface missiles)	37	265.0
Peru		**50.0**
Mirage V fighters	10	50.0
Brazil		**75.0**
Xavante jets	19	75.0
Netherlands		**6.6**
Flycatcher antiaircraft defense system	4	6.6
Switzerland		**Unknown**
Skyguard air defense system	1	Unknown
Skybat air defense system	6	Unknown

[a] Ordered in 1970, delivered in 1981.

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1982 Falklands war further damaged the economy and convinced many senior commanders that they should return to the barracks and focus on correcting the serious military deficiencies highlighted during the conflict. Left without civilian support, the armed forces scheduled elections for October 1983. By mid-1983, the inflation rate had surpassed 300 percent, and an IMF program, negotiated only months earlier to stave off default on the foreign debt, unraveled.

Spending Spree

Following the 1976 coup, the military undertook a major weapons modernization program that was largely unaffected by variations in overall economic performance. The share of the national budget claimed by defense and internal security climbed steadily between 1976 and the onset of worldwide

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1982. At its peak in 1981, military-related expenditures were 22 percent of the budget, slightly less than the combined outlays for health, education, and social welfare. Moreover, these figures exclude the massive expenditures by the vast network of military-owned industries that expanded during this period and includes such diverse businesses as steel mills, arms factories, nuclear research facilities, lumber mills, resort hotels, and gambling casinos. Some academic and other observers estimate that the military's holdings may produce nearly half of GDP. [redacted] 25X1

The massive purchases of weapons began after the Argentines narrowly averted war with Chile in 1978 over the disputed Beagle Channel. Buenos Aires was determined to maintain a large margin of strength over Santiago in preparation for any future confrontation. The US Defense Department estimates that during 1978-81 the Argentine armed forces contracted for slightly more than $3 billion in arms. [redacted]

The Military and Alfonsin

Raul Alfonsin captured the presidency last October largely because of his antimilitary campaign platform. Although reaffirming his commitment to a strong defense establishment during the campaign, he called for an end to the political role of the military and vowed to slash defense spending to provide more funds for social programs and public works. Alfonsin argued that savings could be achieved without diminishing capabilities by improving interservice cooperation, ending redundancy in purchasing, and reducing manpower levels. 25X1 He also hinted [redacted] that reducing tensions with Chile over the Beagle Channel and with the United Kingdom over the Falklands would diminish the need for additional arms purchases. 25X1 [redacted]

The new President moved quickly in the weeks following his inauguration to subordinate the military to civilian authority. He decreed changes in the high-command structure that placed the three service chiefs under the civilian defense minister and created a joint-chiefs system to centralize control. Moreover, he moved the intelligence and internal security services and many of the military-owned industries under civilian control. [redacted] 25X1

Encountering Political Limitations

Despite campaign promises to cut deeply into defense spending this year, we do not expect Alfonsin to provoke the armed forces with massive budget reductions. Evidence indicates that Alfonsin realizes that the commanders, although weak and divided at present, pose the most serious long-term threat to his position. Moreover, beset by growing economic problems and opposition from his Peronist rivals, the President probably wants to avoid a confrontation with the military. [redacted] 25X1

25X1 [redacted] and other Embassy reporting, budget issues have heightened military criticism of the Alfonsin administration. There 25X1 were several reports of anxiety among officers because they believed Alfonsin was willing to cut military expenditures by as much as 70 percent. When Army officers in January had not been paid in nearly two months, this only served to intensify their fears. In March a senior Air Force officer was retired and then arrested for criticizing the new command structure, which he claimed gave the Army and Navy a larger portion of the budget, even though his service outperformed them in the Falklands war. To assuage the Air Force, the Defense Minister stated that the government would continue to fund the costly Air Force missile research program and reiterated his intentions to make only gradual cuts in defense spending. Moreover, [redacted] 25X1 25X1

Although some reductions will be made—and are

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Making Improvement Since the Falklands

The three services have tried to implement lessons learned from the 1982 Falklands defeat. The Navy, shocked by the sinking of the cruiser Belgrano and its inability to counter the British exclusion zone around the islands, has worked the hardest to improve capabilities. The addition of eight previously ordered ships will enhance antisubmarine warfare capabilities, and the delivery of the last of the Super Etendards will improve the Argentines' ability to challenge hostile war vessels. Other Navy measures include: expanding air refueling capabilities, reconfiguring commerical aircraft for maritime patrol missions, and more frequent and realistic exercises to enhance operational readiness.

Air Force commanders have made no major aircraft purchases other than the $110 million worth of Mirages acquired from the Israelis and Peruvians in 1982. Last year the Air Force publicly announced it would not buy any advanced fighter aircraft, ostensibly because of the national financial crisis. Nevertheless, they have requested A-4 fighter aircraft from the United States—now that the arms embargo has been lifted—to replace those lost during the fighting. Like their naval counterparts, commanders have focused on upgrading the capabilities of aircraft already in their inventories, including expanding air refueling capabilities, enhancing onboard avionics, improving weaponry, and providing pilots with more realistic training. 25X1

Although the Army's Falkland war performance was the worst of the three services, commanders have been embroiled in the transition to civilian rule and have taken only tentative steps to address shortcomings. An enhanced air defense capability has been identified as a major need and has been partially fulfilled with the purchase of several Skyguard and Skybat fire control units and French-made Roland antiaircraft missiles. 25X1 25X1

The inability to obtain needed armaments during and after the war reinforced the military's determination to produce domestically some essential equipment. Senior officers hope to improve in-country manufacturing capabilities and to move forward with current and new coproduction and development agreements with West European firms. The military believes enhanced manufacturing capabilities are critical to increasing export sales that would help offset capital investment, research, and development costs. 25X1

expected by senior officers—they are likely to be far less than the rumored 25 to 40 percent and probably will be spread throughout the services to dilute their effects. Ministry of Economy officials recently told US Embassy personnel that defense spending would be cut, but they admitted they are having trouble finding maneuvering room. The national Congress, which must approve the military budget, will probably go along with smaller cuts than they anticipated as long as social welfare and public works programs receive adequate funding. 25X1

Administrative Constraints

A decision to limit budget cuts this year could stem in part from the inexperience of Alfonsin's planners in dealing with the technicalities of the budgetmaking process and a lack of understanding of the military establishment. According to US Embassy reporting, Alfonsin was unaware that the bulk of the military budget went for relatively fixed items—personnel costs and the completion of outstanding contracts. Because Alfonsin plans to cut manpower levels through attrition and a gradual

reduction in conscription, it will take years to reduce an item that takes about half of the military budget. Reflecting on this realization, the Defense Minister in February openly admitted that attacking the military budget was akin to moving a mountain and that gaining full control of the process might take years. [redacted]

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Moreover, the new administration lacks the expertise and staff to dissect defense-related expenditures. [redacted] According to US Embassy officials, at one point early this year only two inexperienced second-echelon planners were working on the military budget. [redacted]

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According to the US Embassy, each service has been allowed to keep representatives in key arms-supplying countries and maintain independent procurement systems. [redacted]

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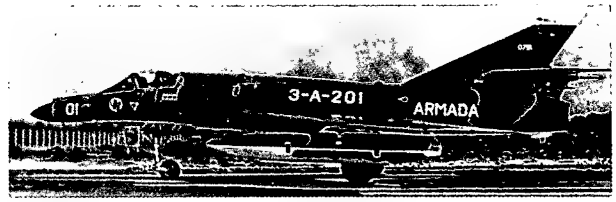
Austerity Impact Ahead

Over the longer term, we judge that the services will be hurt by Argentina's foreign financial squeeze, government austerity policies, and by the increased skill of civilian officials in ferreting out wasteful military spending. The Air Force probably will suffer the most. Although avionics and weaponry are being updated, the expensive replacement of airframes—some dating to the mid-1960s—is not likely soon. The 12 to 24 A-4s the Air Force is seeking from either Israel or the United States



Argentine Super Etendard naval strike aircraft [redacted]

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would only make up for losses during the Falklands war. Even if the transfer is approved by Washington, Alfonsin may balk at large-scale purchases. We strongly doubt the Air Force will receive funds for more advanced fighter aircraft; they instead are likely to further upgrade existing A-4 and Mirage aircraft. [redacted]

The Navy will also be hit by economic stringencies. The Navy's share of the military debt is already by far the largest. Evidence suggests that remaining foreign funds are earmarked for payments to the West Germans for ships and submarines still under construction. Foreign exchange in Navy accounts, while considerable, is probably short of the money needed to meet cost overruns and add-ons for training and more advanced equipment. In addition, according to the US naval attache, Congress will be unlikely to fund longer term procurement needs because of public criticisms for huge past expenditures, a poor showing in the Falklands, and [redacted]

The Navy, as well as the Army, will be hurt by the government's long-term plan to slow military conscription; personnel costs are about half of domestic military spending. Draftees account for nearly 50 percent of the Navy's manpower and nearly 80 percent of the Army's. Alfonsin reportedly believes that recent peace initiatives with Chile and the United Kingdom have reduced personnel needs. Already this year conscription has been cut 15 percent, and the government plans to release 50 percent of the new draftees this July after only five or six months of service. [redacted] 25X1

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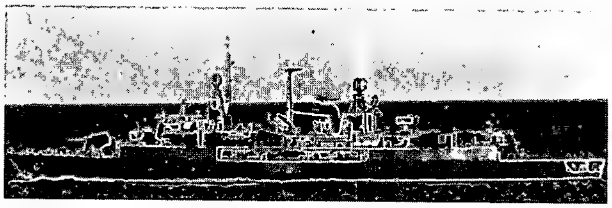

New West German–made MEKO-360 ship

Outlook for Civil-Military Relations

We judge that the military will suffer little this year but will face cuts in 1985 and beyond that eliminate wasteful spending. Most of the recently appointed senior commanders are sympathetic to Argentina's financial plight and will go along with reasonable economies that do not threaten operational capabilities. We foresee little progress in divesting military-owned firms, however, given the size of these holdings, the lack of potential buyers, and their importance in providing jobs.

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Should Alfonsin—under pressure from foreign lenders and leftists—slash defense expenditures, he would face strong military opposition. Even so, cuts in military spending alone have not been sufficient grounds in the past for a military coup. Nevertheless, large budget cuts would serve as a useful rallying point for military opponents of Alfonsin, especially if it appeared that the cuts might dramatically impair the military's ability to carry out its mission.

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Should the government opt for an extended moratorium on foreign debt payments or an outright repudiation—which we judge unlikely—the military response would be mixed and would not pose an immediate threat to Alfonsin. Hardline nationalists, especially in the Air Force, would probably welcome a move against Western banks. The Navy, which reportedly seeks closer ties with the West, would probably oppose it. The Army officer corps would be split. All the services, however, would become concerned about access to weapons in the event of an extended financial break with the West. The greater threat to the Alfonsin government by the military both this year and over the longer term would be a further sharp decline in the domestic economy that sparks widespread labor unrest and rekindles terrorist activity. Alfonsin has committed himself to preventing a revival of mass worker unrest and insurgency. Should the military believe him incapable of maintaining order, officers could begin to reassert themselves to force the President to quell the unrest or face removal from office.

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Implications for the United States

Argentina's current economic difficulties will have little impact on potential arms transfers from the United States. Buenos Aires had been unable to make purchases from the late 1970s until late last year due to restrictions imposed for human rights violations. Certification on human rights last December did not significantly change our military relationship with Buenos Aires. US support for the United Kingdom during the Falklands war only reinforced Argentine beliefs that Washington could not be counted on to fulfill arms contracts. Instead, the military found what it believes are more reliable suppliers in France, West Germany, Italy, and Israel.

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Should Alfonsin be overthrown as a result of the economic crisis, we believe a successor military government will be far more nationalistic. Such a government—whether of the right or left—is likely to blame the United States and other Western countries for failing to provide Argentina with sufficient support and will be difficult to deal with on bilateral issues.

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Israel: A Primer On Triple-Digit Inflation [redacted]

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A surge in consumer prices in the fourth quarter of 1983 resulted in record 191-percent inflation last year, and prices increased at an annual rate of 311 percent during the first quarter of this year. Triple-digit inflation has been the norm since 1978; before that, double-digit inflation existed since 1969. Yet Israel has so far avoided the social and political chaos normally associated with such rapid and persistent inflation. Moreover, any government is unlikely to impose the austerity policies needed to slow inflation unless forced to do so by a foreign exchange crisis. [redacted]

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What Causes Israel's Rapid Inflation?

A major impetus to inflation has been the ability of Israeli labor unions to negotiate real wage gains without comparable increases in productivity. About 90 percent of the civilian labor force belongs to the Histadrut, the large labor federation. A tight labor market—the average unemployment rate since 1968 has been slightly less than 4 percent—has placed the Histadrut in a strong bargaining position. Israeli governments and employers have caved in to union demands rather than risk labor strife, and Histadrut officials know they do not have to moderate their wage demands to protect jobs because Israeli governments are committed to low unemployment. As a result, wages have outrun inflation, and real wages have increased at an annual rate of 6.9 percent since 1975. [redacted]

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Deficit spending is another key contributing factor. According to Israeli Government estimates, the budget deficit in FY 1983 [1] was \$3.2 billion—roughly 13 percent of GNP—and roughly one-third larger in real terms than the FY 1982 deficit. Although the last several budgets have called for real spending cuts, they never materialized. An administrative system to enforce spending ceilings does not exist; as a result, ministers have become adept at claiming that "unanticipated" price rises justify their actual outlays. Israeli law mandates the Bank of Israel to print whatever amount of shekels is required to finance the government's budget deficit, precluding any monetary or fiscal restraint. [redacted]

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Lagging productivity has added to inflationary pressures as well. Productivity has increased at an average annual rate of 1.2 percent since 1972, far short of the official 4- to 5-percent annual targets because of:

- The slow growth in investment in plant and equipment over the last decade.
- The hesitancy of Israeli employers to lay off workers for fear of being caught short when demand strengthens.
- Very high marginal tax rates that reduce worker incentives; an average income earner is in the 60-percent tax bracket.
- Use of work time to engage in such activities as phoning brokers and checking the financial pages of newspapers to juggle portfolios to hedge against inflation. [redacted]

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Without Israel's comprehensive system of indexation, the increasingly higher rates of inflation probably would not have been possible. The price of virtually every commodity and service is indexed. As a result, any economic shock boosts prices almost immediately, and the indexation system tends to sustain a more rapid inflationary momentum. [redacted]

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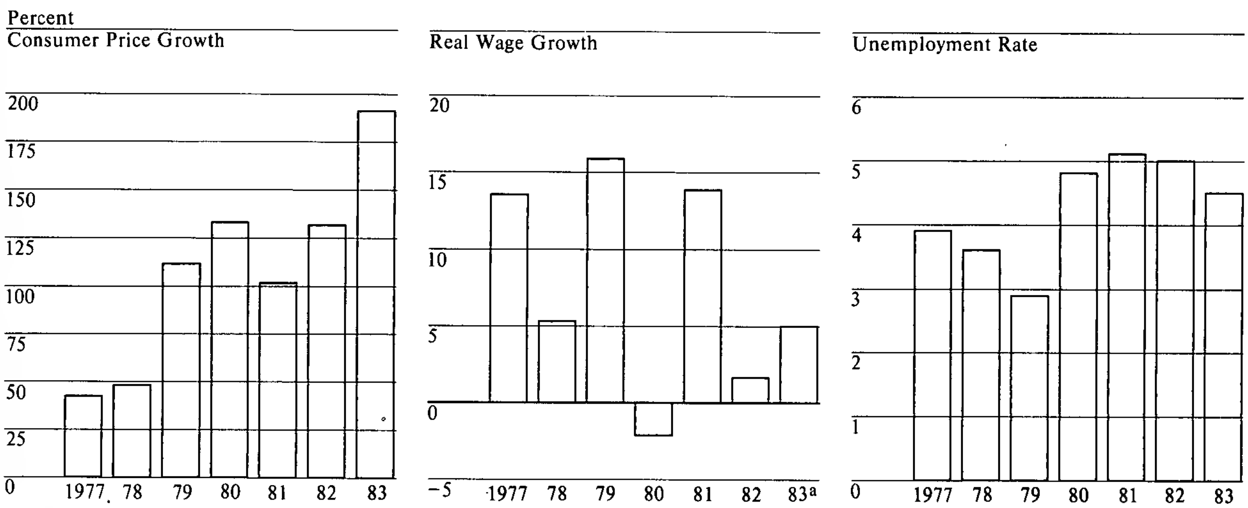
[1] The Israeli fiscal year begins on 1 April. [redacted]

Israel: Prices, Wages, and Unemployment



[a] Estimated.

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Aren't Defense Expenditures Largely Responsible for Inflation?

Although the defense burden, by contributing to the government's deficit spending, is a factor, we do not believe it is any more important than other spending items. Moreover, roughly one-third of the defense budget is covered by US military assistance. Instead, it is the Israeli reluctance to skimp on either guns or butter that helps fuel inflation. We believe Israeli officials are embued with a deeply ingrained conviction that Israelis have earned the "good life" from a material viewpoint because of the sacrifices required for the survival of the state—almost every family has been touched by death or serious injury during one of Israel's wars.

Will Rapid Inflation Continue?

We believe it will be almost impossible—particularly if the government engages in "pump priming" before the July election—to keep this year's inflation rate below 300 percent. An 18.6-percent devaluation of the shekel and a boost in most government-controlled prices by 50 percent in October resulted in a record 21.1-percent monthly inflation rate; double-digit price hikes have occurred in each of the following months. Israeli inflation, once it speeds up, has proved almost impossible to slow. Only in one of the past nine years—1981—has the rate slowed, and that was because then Finance Minister Aridor was temporarily keeping price rises low by increasing subsidies and cutting purchase taxes, which are included when calculating the consumer price index. 25X1

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How Do Israelis Cope?

Most Israelis are protected from the ravages of triple-digit inflation by a comprehensive system of

indexation. Wages are indexed at 80 to 90 percent of the increase in the consumer price index (CPI), depending on the inflation rate, and adjustments are made quarterly. Pay hikes in addition to indexation are negotiated both at the industry and plant levels. A Histadrut official recently told a US Embassy officer that labor plans to offer two proposals in negotiations to replace the current agreement that expired on 1 April—monthly adjustments at 80 percent of the CPI or the current quarterly formula with advance payments if the CPI rises by more than a specified rate. Pensions and welfare payments are fully linked to the CPI, with quarterly adjustments. Tax brackets are adjusted quarterly by 100 percent of the consumer price rise. 25X1

Most financial assets are indexed. The principal on long-term savings accounts is fully linked to the CPI, and Israelis earn positive real rates of return averaging 3 percent. The US Embassy reports that banks have developed schemes that link savings with the CPI, foreign currencies, or some combination of the two; in some cases, savers can wait until the maturity date to choose the indexing formula that provides the highest return. Government-issued bonds are indexed and have a real rate of return of about 3 percent. 25X1

Although the indexation scheme protects most Israelis from inflation, it helps perpetuate inflation and reduces the government's incentives to attack the price spiral. As long as Israelis believe the indexation system works, they are not willing, in our view, to pay the price of reduced living standards and higher unemployment that would be required to cut the pace of price hikes. As a result, Israeli politicians over the years have responded to accelerating inflation by increasing the amount and frequency of indexation adjustments. 25X1

What Are the Costs of Inflation?

We believe the major cost of inflation is the debilitating effect on plant and equipment investment, which limits the potential for future growth. Investors, who are unable to foresee with confidence real rates of return on physical projects because of uncertainty over expected cost and price increases, have diverted their funds to indexed financial assets with a real rate of return that is guaranteed. According to Israeli statistics, plant and equipment investment has grown 1 percent annually over the last decade, and its share of GNP has declined from 21 percent to 17 percent since 1973. 25X1

Rapidly rising prices have rendered the budget process almost meaningless. Recent budgets have been based on unrealistically low inflation estimates—the original FY 1983 budget assumed price hikes of 90 percent—because this is politically expedient. The recently passed budget for FY 1984 is, in fact, only a spending blueprint for the first quarter of the fiscal year that will be updated based on inflation, unemployment, and other factors, including the upcoming election. We believe this procedure removes what little restraint ministers might have felt when making their spending plans. Because Finance Minister Cohen-Orgad has no administrative or political ability to enforce spending discipline, he will have little choice but to follow the procedure of recent years—submit a supplemental budget at the end of the fiscal year to cover actual outlays. 25X1

What About the Balance of Payments?

Israel's growing foreign payments problems stem from demand pressures generated by real wage gains and government spending. Rapid inflation has little impact on the balance of payments as long as Israel's exchange rate is allowed to move freely. Until October 1977, officials periodically devalued the currency (at that time the Israeli pound) to reflect the difference between Israel's inflation rate and trading partners' price rises. With the elimination of foreign currency controls in October 1977, the government has, for the most part, allowed a "dirty" float—the exchange rate has moved on a daily basis with only short-term intervention by the Bank of Israel to smooth the impact of irregular capital flows. 25X1

For almost a year beginning in the fall of 1982, however, the depreciation rate of the shekel was deliberately slowed by former Finance Minister Aridor in an effort to cut the inflation rate by making imports cheaper in shekel terms than they otherwise would have been. This reduced the competitiveness of Israeli exports, however, at a time when the global recession was already decreasing the demand for Israeli goods. Aridor's shekel policy contributed to the $400 million increase in the trade deficit in 1982 and $500 million last year. 25X1

Implications for the United States

A two- to three-year austerity program probably would be required to significantly reduce Israel's inflation rate. Because the public appears to be willing to live with triple-digit inflation as long as its standard of living continues to rise, we believe whatever government emerges after the July elections is unlikely to implement a serious anti-inflation policy unless shrinking foreign exchange reserves force its hand. To stave off a foreign exchange crunch, we believe the next Israeli government will take the same approach as past governments—turn to the United States for more aid. 25X1

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The USSR's New Long-Term Energy Program

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The recently published *Long-Term Energy Program of the USSR* is an ambitious set of objectives and plans for improving all aspects of the Soviet energy system. Although the program cites no specific production targets, the trends described indicate rising production. Broad goals are laid out for energy production, conservation, and substitution and for specific sectors of the economy—machine building and transportation, for example—that support the energy sectors. The importance of continued energy exports is noted, but no goals are stated. The program, first previewed in mid-1983, was published in March in the newspaper *Ekonomicheskaya Gazeta,* apparently after long debate within policymaking circles. Like other recent Soviet plans, the energy program appears to rely heavily on improvements in capital and labor productivity. In view of the economy's poor record in achieving productivity increases since the mid-1970s, we believe that many of the program's goals are beyond reach, although substantial progress can be expected in some energy sectors.

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The Program Through the Year 2000

The 20-year program is divided into general objectives for two periods, 1981-90 and 1991-2000. The first phase focuses on energy production, principally oil and gas; the second phase concentrates on energy conservation, interfuel substitution, nuclear power production, and expansion of the coal industry.

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None of the energy-producing sectors has been neglected. Each of them—oil, natural gas, coal, and electric power—will require an increase in investment. The Soviets, however, have never been able to expand rapidly the output of all energy sectors simultaneously. We do not believe they can do so in this program without a substantial increase in investment at the expense of other sectors of the economy—an increase greater than that indicated by the published program.

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Oil

The program's references to oil production are somewhat vague. Phrases such as "securing a stable, high level of oil output" and "an increase in liquid fuel" are difficult to translate into output targets. Moreover, there appears to be a major inconsistency between the program's target for drilling and recently discussed goals. The "stable, high" level of production will require, according to the program, a doubling of drilling capacity by 1990 (compared with 1980). This contrasts with recent Soviet press articles that indicate that drilling meterage must double every five years to maintain stable output. This five-year doubling of drilling implies an annual rate of at least 70 million meters in 1990, far more than the 35-40 million meters the energy program suggests.

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The program is counting on improving production in existing oilfields by raising well flow rates and ultimate oil recovery through better equipment and technology. A program to improve substantially the operation of the oil ministry's 100,000 wells will be highly capital intensive—with an emphasis on pumping equipment—and require a dramatic improvement in labor productivity. The new energy program also stresses broad introduction of enhanced oil recovery (EOR) methods, but the Soviet effort to date has been beset by problems. These projects are expensive, require long leadtimes, must be tailored to individual fields, and yield uncertain results. Current oil production by EOR methods is

Main Objectives of the Long-Term Energy Program

- *Energy savings through accelerated technical progress to reduce energy use per unit of output.*
- *A speedup of technical progress in machine building and related branches of industry to supply appropriate equipment and materials to the energy sector.*
- *Growth rates for electricity output that are higher than those for primary energy production.*
- *Accelerated development of the natural gas industry to satisfy domestic consumption and export needs.*
- *Provision of a "stable, high level" of oil output partly by increasing the amount of oil ultimately recovered from oil deposits.*
- *"Early preparation" of industrial stocks of fuels, especially oil.*
- *A sharp increase in drilling meterage and improved efficiency of deep exploratory oil drilling.*
- *Assured growth in the supply of motor fuels, mainly through "deeper" refining of oil and a substantial reduction in oil used at electric power stations.*
- *Production of synthetic liquid fuels from gas, coal, and oil shale.*
- *"Forceful" development of nuclear energy to release significant quantities of fossil fuels for other uses.*
- *Construction of pumped-storage hydroelectric plants in the European part of the country.*
- *Development of the coal industry, principally through increased output of open pit mines in eastern regions and accelerated construction of large thermal power plants using this coal.*
- *"Economically justifiable coordinated development" of hydroelectric resources in Siberia, the Far East, and Central Asia.*
- *Creation of the technological and material base necessary for the development of new energy sources such as fast breeder reactors and thermonuclear fusion.*
- *Expanded use of renewable energies (solar, geothermal, tidal, wind, and biomass).*
- *Optimal combination of different modes of transport in the European USSR for moving large quantities of energy resources from eastern regions, above all from Siberia where most of the growth in fossil fuel output will take place.*
- *Guarantee of the necessary amounts of fuels and electricity for export, primarily for the solution of energy problems in "socialist" countries.* 25X1

only about 60,000 barrels per day (b/d). We estimate that by 1990 EOR production will be no more than 200,000 b/d—a substantial gain, but not enough to exert a major influence on the level of Soviet oil production. 25X1

Natural Gas

The energy program touts gas as the growth fuel, at least until coal, nuclear energy, and renewable energy sources are expanded sufficiently in the 1990s. Gas output is to rise to an unspecified maximum level in the mid-1990s and then stabilize. In the 1991-2000 phase of the program, West Siberian fields smaller than those now in production will be developed, and this will raise investment requirements. The program also raises the possibility of a new West Siberian export pipeline to supply additional gas to Eastern Europe. This pipeline would be built with the participation of East European countries. 25X1

Coal

The Soviet coal industry has been plagued with problems since the mid-1970s. The energy program apparently recognizes the difficulty of quickly raising production and indicates that the first phase (1981-90) will be used to lay the groundwork for an acceleration of coal production in the 1990s. By the end of this century, 56 to 60 percent of Soviet coal is to be produced by open pit mining (mainly in Siberia), compared with 38 percent in 1980. Plans also call for a 50-percent increase in coal cleaning plant capacity between 1980 and 2000. All of these efforts will be expensive and will require a higher priority for coal industry investment, which has been nearly stagnant since 1977. 25X1

Electric Power and the Nuclear Program

One of the energy program's main objectives is to guarantee growth rates for electricity production that are higher than those for primary energy production. We believe this may be, in part, an attempt to eliminate the effect of electric power outages on oil and gas production. To assure strong growth of electricity output, the Soviets intend to:

- Rapidly expand nuclear electricity production.
- Lower the share of oil used to produce electricity through substituting natural gas, constructing nuclear heating plants, using inexpensive coal from open pit mines, and building large hydroelectric plants in eastern regions of the country.
- Complete the country's Unified Electric Power Network, add more plants to generate electricity during peak demand periods, construct ultra-high-voltage transmission lines, and increase the reliability of delivered electricity.
- Further develop combined heat and power plants.
- Modernize or retire small, inefficient power plants. 25X1

The most ambitious of these efforts is the expansion of the nuclear power program. Plans call for the equivalent of 6.3 million b/d of fossil fuel to be replaced by "other energy sources" by the year 2000. Given Soviet expectations for hydroelectricity and unconventional energy sources, we calculate that about 85 percent of this "saving" is expected to come from nuclear power. This implies production of about 1.3 trillion kilowatt-hours (kWh) of nuclear electricity in 2000, 12 times the 1983 level.[1] We are currently projecting nuclear electricity output to be less than 300 billion kWh in 1990. We do not believe the Soviets can build enough nuclear power plants to more than quadruple output between 1990 and 2000. 25X1

Energy Conservation and Substitution

Despite the many references to energy savings, the conservation targets are not ambitious over the near term; they represent no improvement from the

[1] This total includes the electricity equivalent of the output of nuclear heating plants. 25X1

savings of 2 million b/d of oil already planned for 1981-85. The contribution of conservation, however, is supposed to become more important in the 1990s. Total annual savings of fuel and energy resources by 2000 are given as 7.6-8.1 million b/d oil equivalent (compared with 1980) or an average of 1.9-2.0 million b/d per five-year period. [redacted] 25X1

To prepare for transferring the Soviet economy to an "energy-conserving development path," the program calls for reducing the "energy intensity" of the economy. Measured by the ratio of total energy consumption to national income, energy intensity will be reduced by 12 to 17 percent over the 20-year period. Here again the Soviets do not show the same optimism associated with expanded energy production. This decline in the energy-to-national-income ratio (as calculated by the Soviets) averages only 0.6 to 0.9 percent per year, compared with actual reductions averaging 1.3 percent annually in 1981-82. [redacted] 25X1

Energy conservation, however, will not be cheap. The program calls for "massive" production of energy-conserving equipment and equipment for regulating and measuring energy use. [redacted] 25X1 25X1 25X1 Little "conservation equipment" is now produced in the USSR. A nationwide program of intensive energy conservation will require either large amounts of imported equipment or new plants to produce this equipment. Either alternative will be expensive. [redacted] 25X1

Interfuel substitution also plays a role in the energy program. During the 20-year period, the Soviets foresee a decline in the use of oil and a rise in the use of coal, nuclear power, and natural gas. The share of electricity produced by oil in thermal power plants—35.7 percent in 1980—is to be reduced by more than half by 1990. We calculate that the Soviets expect to cut annual heavy fuel oil use by about 1 million b/d in 1981-90, also through new investments. For example, investment in oil refining will have to rise. The long-postponed investment in cracking equipment needed to boost output of light petroleum products (gasoline, diesel fuel, and jet fuel) by processing the fuel oil displaced by other energy sources will be expensive, and much of this equipment may have to be imported. [redacted] 25X1

Investment Implications

The energy program estimates that energy's share of total capital investment will average 20 to 22 percent over the 20-year period—a slight increase from the present share. We estimate that the Soviets, relying heavily on the achievement of unrealistic productivity goals, have underestimated total investment requirements. The new energy program anticipates that oil investment will continue to grow, while coal, oil refining, machine building, and other relatively neglected branches are to also receive substantial increases in investment. [redacted] 25X1

We do not believe the Soviets can achieve all of these ends with only a slight increase in the share of investment devoted to energy. Under less demanding conditions in recent years, energy investment has risen rapidly—at an average annual rate of 8.1 percent between 1977 and 1982, compared with total investment growth of only 3.3 percent. [redacted] 25X1

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